UNITED STATES DEPARTMENT OF AGRICULTURE
FARM CREDIT ADMINISTRATION
WASHINGTON, D. C.

SUMMARY OF CASES

RELATING TO

FARMERS' COOPERATIVE ASSOCIATIONS

*

*   *

Prepared by

Lyman S. Hulbert

Attorney
Office of the Solicitor
Washington, D. C.

For the

COOPERATIVE RESEARCH AND SERVICE DIVISION

Summary No. 42 June 1949

TABLE OF CONTENTS

	Page
Reserves - Neither Excludable Nor Deductible	1
Is "Interest" Deductible?	4
Profits of Subsidiaries Taxable to Them	9
Landlord Buying Tenant's Share - Income Taxes	13
Exemption Loss - No Records	16
New Directorships Not Vacancies	18
Nonprofit Cooperative Not an Employer Under Workmen's Compensation Law	20

RESERVES - NEITHER EXCLUDABLE NOR DEDUCTIBLE

The Circuit Court of Appeals in Fountain City Cooperative Creamery Association v. Commissioner of Internal Revenue, 172 F. 2d 666, affirmed the judgment of the Tax Court, 9 T.C. 1077, Summary No. 37, p. 1.

The question for decision was whether the sum of $5,088.55, which the association had set up in 1943 as a "patrons' equity reserve" was deductible or excludable in computing income taxes to be paid by this nonexempt association. The organization papers of the association did not contain any contractual obligation requiring the association to account to its patrons for any excess over operating and maintenance costs and expenses. The opinion of the Circuit Court of Appeals is here given in full:

"MINTON, Circuit Judge.

"The Commissioner of Internal Revenue found and declared a deficiency in the income and declared value excess profits tax against the petitioner-taxpayer in the sum of $1,535.77. The Tax Court sustained the action of the Commissioner, and the taxpayer has appealed.

"The taxpayer is a corporation of Wisconsin and claims to operate as a cooperative association under the laws of that state. It was engaged in the buying and selling of butter and in the buying and processing of butterfat. The taxpayer's patrons consisted of producers of butterfat, of whom some were stockholders of the association and some were not. Stock dividends not to exceed five per cent had previously been declared by the association but no consideration had been given to a distribution to patrons until 1943. In its tax return for 1943, the taxpayer showed a gross income of $63,383.45 and claimed deductions of $62,794.04, which included the sum of $5,088.55 which the association had set up in 1943 as a 'Patrons' Equity Reserve.' The reserve was set up for the butterfat patrons, whether stockholders or not. It is the amount of additional tax resulting from the disallowance of the deduction from gross income of this $5,088.55 which has given rise to this litigation.

"It is the taxpayer's contention that this sum was always the property of its patrons, derived from net proceeds which were required by the statute of Wisconsin to be distributed annually, and therefore the sum should never have been included in the gross income of the taxpayer. The statute provides that 'the directors * * * shall apportion the net proceeds of the business at least once annually * * *.'

"What part of those proceeds belonged as a matter of right to the patrons? What part, if any, should go to the patrons rested in the discretion of the board of directors or a majority of the stockholders. Pearson v. Clam Falls Co-op. Dairy Ass'n, 243 Wis.

369, 374, 10 N.W. 2d 132, 134. Until distributed, it all belonged to the association.

"Since the taxpayer had at the beginning of 1943 accumulated a surplus of $26,430.53, the directors obviously had not distributed annually all the net proceeds except in the sense that they were recognized as surplus. This, of course, is not a showing that the net proceeds were the patrons' property. When the taxpayer's board of directors came to make a distribution on December 14, 1943, after declaring a five per cent stock dividend it resolved:

"'* * * that all the remaining net income for said fiscal year is hereby distributed among the patrons of this association, both members and nonmembers, in the form of patrons equity reserve, in proportion to the monetary value of the dairy products delivered to the association during said fiscal year.'

"The statute contemplates that such patron dividends shall be paid in cash or stock. Section 185.16, Wis. Stat. 1943. This so-called patrons' equity reserve was set up on the books, and certificates to patrons were issued against it. These certificates could not be converted into cash or stock to be paid out of the reserve in any event. Instead, the certificates provided that the holder had 'a conditional equitable interest' in the reserve and if 'in the opinion of the Board of Directors of said Association the cash reserves are greater than are reasonably necessary for sound financing of the Association' such excess cash may be used to pay off these 'conditional equitable interests' in the patrons' equity reserve. On the other hand, if the association had a loss, the directors might apply the patrons' reserve in its entirety to meet that loss. The certificates were transferable only on the books of the association and drew interest only if the directors so ordered. The debts of the association were prior to this reserve, and finally, upon liquidation of the association, if there were any of these so-called 'conditional equitable interest' certificates in existence, they did not even stand above the rights of the common stockholders but had to share whatever was left, after payment of debts, with those stockholders. The certificates were issued pursuant to an amendment of the bylaws made at the annual stockholders' meeting on February 2, 1944, at which meeting the resolution establishing the patrons' equity reserve made on December 14, 1943, was ratified and approved and the bylaws amended to set forth the limitations that were incorporated in the certificates as indicated.

"It is clear from the foregoing that instead of this patrons' equity reserve belonging to the patrons, it never left the control of the association which continued to treat it as its own. Its creation lay within the absolute discretion of the taxpayer's directors or stockholders and after creation, its continued existence was wholly at the will of the taxpayer's directors. This

reserve never belonged to the patrons. It was and always remained the property of the taxpayer and was properly included by the Commissioner in the taxpayer's gross income.

"This judgment of the Tax Court is affirmed."

As shown by the foregoing opinion it was argued that the statutory provisions under which this association was incorporated resulted in the "patrons' equity reserve" being the property of the patrons. If the reserves as a matter of law were the property of the patrons at the time of receipt by the association, then obviously the association could not be required to pay income taxes on property belonging to others.

It will be recalled that in the case of San Joaquin Valley Poultry Producers Association v. Commissioner of Internal Revenue, 136 F. 2d 382, Summary No. 19, p. 8, the court held that inasmuch as the reserves involved were, under the organization papers of the association and the statute of California under which the association was incorporated, the property of the patrons of the association, on a patronage basis, the nonexempt association was not required to pay income taxes on such reserves. Apparently, such reserves were not regarded as having the status of income to the association at any time. In other words, the organization papers and the statutory provisions in question, which obviously were in existence before the transactions which resulted in the money from which the reserves were set aside, were regarded as keeping the reserves from having the status of income to the association.

Apparently, in the case under discussion it was argued that the same principles which were applied in the San Joaquin case should be applied in the case at bar. This view appears to have been rejected primarily because the statute contemplated that patronage refunds would be "paid in cash or stock," and they were not "paid" in this way. As shown by the foregoing opinion of the Circuit Court of Appeals, the association contended that the certificates which it had issued on a patronage basis covering the reserves were regarded as payment, and it was argued that this resulted in making the patrons the owners of the reserves. The court, however, called attention to the fact that the certificates could not be converted into cash or stock to be paid out of the reserves in any event. The court also emphasized that in the event a loss occurred the patrons' equity reserve might be used to meet that loss. The court also stressed the fact that all debts of the association were prior to the reserve and that in liquidation they were only payable after the common stockholders had been paid. It is believed that these various matters were referred to for the purpose of showing that the patrons were not actually the owners of the reserves. Attention is called to the fact that in the San Joaquin case the association was under no obligation to pay the patrons the amount of such reserves. In fact such reserves apparently could have been in whole or in part exhausted.

Except in instances in which the principle announced in the San Joaquin case is found to be applicable, it is believed that the only instances in which a nonexempt organization is entitled to exclude or deduct

patronage refunds are where such patronage refunds are paid in pursuance of a prior mandatory obligation to make them, thus amounting to indebtedness, and instances in which the excess amounts over operating and maintenance costs and expenses have been furnished and received as capital.

In the case of United Cooperatives, Inc., v. Commissioner of Internal Revenue, 4 T.C. 93, Summary No. 24, p. 1, the excess amounts had been refunded in the form of capital stock, and they were required to be refunded in this manner. It was held that the amounts represented by the certificates of stock had been furnished and received as capital, and as capital is never income it is always excludable in computing income taxes.

If the excess amount over operating and maintenance costs and expenses has the status of indebtedness, namely, if the association is obligated to refund this amount at the time of receipt, such excess would not have the status of income, and hence could be excluded. Moreover, it would appear that such excess, if it has the status of indebtedness, could probably be deducted as an ordinary and necessary expense within the meaning of section 23 of the Internal Revenue Code. In American Box Shook Association v. Commissioner of Internal Revenue, 156 F. 2d 629, it was said:

> "In order to be a true cooperative, however, the decisions emphasize that there must be a legal obligation on the part of the association, made before the receipt of income, to return to the members on a patronage basis, all funds received in excess of the cost of the goods sold. Such an obligation may arise from the association's articles of incorporation, its by-laws, or some other contract." (Underscoring added.)

In the case last cited, the court refused to allow cash patronage refunds amounting to nearly $8,000 to be excluded in computing the income taxes of the American Box Shook Association because the association was not under a mandatory obligation to make them. In view of this fact it is not surprising that the court in the case under discussion refused to allow the amount represented by the certificates, issued without a mandatory obligation to do so, to be deducted or excluded. If cash patronage refunds voluntarily paid may not be excluded, one could hardly expect the amount represented by certificates voluntarily issued, and without due dates, and which could be wiped out by the association, to be excludable.

IS "INTEREST" DEDUCTIBLE?

The following is an opinion by Goldsmith, Siegel & Goldsmith of Portland, Oregon, on the question of whether interest paid on capital reserve certificates would be deductible for income tax purposes:

Name of Cooperative
Omitted on Purpose

"May 11, 1949

"Gentlemen:

"You have asked our opinion as to whether interest paid on your capital reserve certificates would be deductible for income tax purposes, assuming the association operated on a non-exempt basis.

"Section 23 of the Internal Revenue Code which authorizes the deduction of interest reads:

> "'In computing net income there shall be allowed as deductions * * * (b) Interest. All interest paid or accrued within the taxable year on indebtedness * * *.'

"Treasury Regulations, Section 29.23b(1), reads:

> "'So called interest on preferred stock which is in reality a dividend thereon, cannot be deducted in computing net income.'

"The problem is to determine whether capital reserve certificates of . . . have characteristics which have been interpreted as those of preferred stock or indebtedness. The answer to this problem must be based on an analysis of the . . . certificates.

"1. CHARACTERISTICS OF THE CAPITAL RESERVE CERTIFICATES OF . . .

"We will assume for purposes of this opinion that the capital reserve certificates are based on the by-laws as currently amended. Early issues of your capital reserve certificates providing for interest at a rate to be declared by the board, would make a very difficult case for deductibility. The present by-law provisions indicate mixed characteristics of indebtedness and capital contribution. While it is probable that by-law provisions for a fixed interest rate would supersede provisions in earlier certificates for discretionary interest, such later provisions could not affect such statements as 'This certificate does not represent a debt of the Association to the holder or owner * * *'. (Elko Lamoille Power Co. 9th CCA, 50 F(2) 595) Such a statement appears in one of your early certificates according to our files.

"Pertinent current by-law provisions as to capital reserve certificates are:

"(a) '* * * the excess shall belong to the patrons on a basis of patronage, and such part as is not paid out as patronage refunds shall be considered contributions by such patrons to the capital of the association for which they shall be issued capital reserve certificates.' ARTICLE VIII, Section 1.

"(b) 'There shall be created a capital reserve which shall be considered part of the capital of the Association.' ARTICLE VIII-A, Section 3.

"(c) 'There shall be issued to each patron, one or more capital reserve certificates evidencing his proportionate interest in the allocated patrons' reserves of the Association.' ARTICLE VIII-A, Section 4.

"(d) 'Interest shall be paid on all unretired balance of outstanding capital reserve certificates at the rate of 3% per annum, and such interest shall be considered an operating expense.' ARTICLE VIII-A, Section 5.

"(e) 'All capital reserve certificates are subordinate in right to the claims of all present and future creditors of the Association * * *.' ARTICLE VIII-A, Section 7.

"(f) Provisions for retirement of certificates at discretion of board, making no mention of accrued interest unpaid, there being added to such provisions: 'Provided, however, that the board of directors may retire not to exceed $10,000 of capital reserve certificates of any holder upon notice of his death * * *.' ARTICLE VIII-A, Section 8.

"(g) Provisions for redeeming capital reserve certificates and capital stock pro-rata on dissolution. ARTICLE VIII-A, Section 9.

"(h) Provisions for transfer by endorsement, surrender to association and reissue to transferror; limitation of liability of association to make payment only to record holders of certificates. ARTICLE VIII-A, Section 9.

"The file copy of what appears to be the latest association certificate headed 'Multiple Series Capital Reserve Certificate', refers to most of the above mentioned provisions and also contains the language:

> '* * * hereby certifies that ________________ * * * has an interest in the capital reserve of the association in the sum of ________________ Dollars * * *.'

"2. DO THE COURTS ACCORD OBLIGATIONS WITH SUCH CHARACTERISTICS THE STATUS OF INDEBTEDNESS OR OF CAPITAL CONTRIBUTIONS?

"There is a welter of often conflicting legal authority on this problem, but the only U. S. Supreme Court decision on this question indicates that there is no one characteristic which can be said to be decisive in the determination whether annual payments under a corporate obligation are interest or dividends. The John Kelley Co. & Talbot Mills, 326 US at 530, 90 L.Ed at 283-284. In other words,

the problem must be decided as a question of fact in each case, whether considering all the criteria of the obligation, it constitutes an indebtedness or a contribution to capital.

"Among such criteria which have been held material to determination of this question are the following, together with their application to the characteristics of . . . certificates:

CRITERIA	APPLICATION
"a. Name of obligation	'Capital reserve certificate' indicates contribution to capital
"b. Intent of parties	clearly intended as contribution to capital; express language of by-laws and treatment for accounting purposes both evidence such intent
"c. Certainty of payment	fixed interest. . . indebtedness
"d. Maturity date	no fixed maturity; association may redeem up to $10,000 on death might be argued to be fixed maturity . . . contribution to capital
"e. Payments only out of net earnings indicate contribution to capital	fixed interest to be considered an operating expense . . . indebtedness
"f. Right to share in profits indicates contribution to capital	no such right accorded certificate holders . . . indebtedness
"g. Subordination to claims of creditors indicates contribution to capital	clearly provided for . . . as a matter of fact certificates do not have priority over common stock on dissolution usually accorded preferred stock (contribution to capital)
"h. Voting rights indicates contribution to capital	no such right . . . indebtedness
"i. Ratio of debt to capital if obligations held to be indebtedness. Recent cases increase importance of this factor.	Ratio of capital reserve certificates to net worth shown in debenture prospectus is 10-1. Such ratio would strengthen conclusion that obligations are contributions to capital.
"j. Right to enforce payments in default indicate indebtedness	apparently no such right explicitly contribution to capital

"This opinion is based on research in the following sources:

Prentice-Hall Tax Guide
Rabkin & Johnson's 'Federal Income & Estate Taxation'
Commerce Clearing House Tax Service
NYU Institute of Federal Taxation (5th, 6th & 7th)
Judge Hulbert's 'Summary of Cooperative Cases', the
30th and 26th of which Summaries dealing with the subject.

"The cases which dealt with cooperative associations did not indicate any variation from the general criteria above set forth. The only recent decision (1942) involving cooperatives, Gallatin Farmers Co., 132 F2nd 706 9th Circ., appeared to assume that a cumulative dividend on preferred stock would not be deductible, the decision going off on other grounds than the nature of the dividend.

"No case has been located dealing with a security similar to . . . capital reserve certificates, nor is it our opinion that any of the decisions of the Ninth Circuit Court of Appeals (which would be the appellate court in this area) are determinative of the problem.

"CONCLUSIONS:

"Since, as perusal of the above mentioned criteria indicates, the capital reserve certificates have certain characteristics of indebtedness and also certain characteristics of preferred stock, it seems probable that a claimed deduction of interest would be contested by the Treasury Department. In our opinion the better possibility in the event of such contest is that the interest would be held nondeductible, on the theory that it is not paid on indebtedness. The factor of fixed interest payments, irrespective of earnings, which is the most powerful argument for holding the payments to be deductible interest, is more than offset, in our opinion, by the repeated indications that the parties intend the certificates to be contributions to capital and not debts, and furthermore the fact that the securities do not have a fixed maturity. The recently added provision that the directors may redeem the certificates on death of a holder is not phrased so as to place an absolute obligation on the part of the directors to redeem the certificates in such event, but merely confers power on the directors to so act. Furthermore there is language in the decisions of the Ninth Circuit Court of Appeals decisions that the burden of showing the deduction within the provisions of the taxing acts in a case such as this, is upon the taxpayer. Pacific Southwest Realty Co. 128 Fed 2nd 815. Such language would appear to throw the decision in the direction of the Commissioner in the event that the factors on either side were approximately equal.

Yours very truly,

GOLDSMITH, SIEGEL & GOLDSMITH"

PROFITS OF SUBSIDIARIES TAXABLE TO THEM

The case of National Carbide Corporation, et al. v. Commissioner of Internal Revenue, 93 L. Ed. 634, involved the question of whether the admitted profits of three wholly owned subsidiaries were taxable to the subsidiaries or whether they were taxable to the Air Reduction Corporation, which owned all the stock and which furnished through loans or capital contributions the money which was necessary for operating the business conducted by each subsidiary. Each subsidiary contracted to pay its net profits less an amount equal to six percent on its stock to the parent corporation. One of the subsidiaries engaged in the manufacture and sale of calcium carbide; another in the manufacture and sale of carbon dioxide; and another in the manufacture and sale of welding machines, equipment, and supplies. None of the subsidiary corporations purchased any commodities from the parent corporation, and none of the subsidiary corporations made any sales to the parent corporation.

The Air Reduction Corporation, referred to as "Airco" in the Supreme Court opinion, entered into comprehensive contracts with each of the subsidiary corporations. The Supreme Court described these contracts as follows:

> "The contracts between Airco and its subsidiaries provided, in substance, that the latter were employed as agents to manage and operate plants designed for the production of the products assigned to each, and as agents to sell the output of the plants. Airco was to furnish working capital, executive management and office facilities for its subsidiaries. They in turn agreed to pay Airco all profits in excess of six percent of their outstanding capital stock, which in each case was nominal in amount. Title to the assets utilized by the subsidiaries was held by them, and amounts advanced by Airco for the purchase of assets and working capital were shown on the books of the subsidiaries as accounts payable to Airco. The value of the assets of each company thus approximated the amount owed to Airco. No interest ran on these accounts.
>
> "Airco and its subsidiaries were organized horizontally into six over-riding divisions: corporate, operations, sales, financial, distribution, and research. Officers heading each division were, in turn, officers of the subsidiaries. Top officials of Airco held similar positions in the subsidiary companies. Directors of the subsidiaries met only to ratify the actions of the directors and officers of Airco.
>
> "Airco considered the profits turned over to it by the subsidiaries pursuant to the contracts as its own income and reported it as such. Petitioners reported as income only the six percent return on capital that each was entitled to retain. Similarly, in declaring the value of their capital stock for declared value excess profits tax purposes, the subsidiaries reported only the nominal amounts at which the stock was carried on the books of each. The Commissioner

notified petitioners of substantial income and excess profits tax deficiencies in their 1938 returns, having taken the position that they are taxable on the income turned over to Airco as well as the nominal amounts retained. The Tax Court held, however, that the income from petitioners' operations in excess of six per cent of their capital stock was income and property of Airco. Three judges dissented. The Court of Appeals for the Second Circuit reversed. 167 F 2d 304. We granted the petition for a writ of certiorari, 335 US 810, ante, 17, 69 S Ct 44, because of this conflict of opinion and the disagreement between courts as to the continuing vitality of Southern P. Co. v. Lowe, 247 US 330, 62 L ed 1142, 38 S Ct 540 (1918)." (Underscoring added.)

It was apparently the contention of the subsidiaries that the corporate entity of each of them should be disregarded, and that for tax purposes the profits of each of the subsidiaries should be treated exactly as though they had been earned by the parent corporation. The Tax Court had held, 8 T.C. 594, that the corporate form of each of the subsidiaries might be so disregarded. The Circuit Court of Appeals, in 167 F. 2d 304, reversed the Tax Court, holding that the subsidiaries were independent entities, and that all the profits made by them were taxable to them. The Supreme Court of the United States in affirming the decision of the Circuit Court of Appeals said in part:

"The theory upon which the Tax Court expunged the deficiencies apparently was that since the Southern P. Co. Case was not expressly overruled by Moline Properties, the 'business purpose' rule laid down in the latter is not absolute, but that the corporate entity may be disregarded (or the corporation treated as an agent of its owner) for tax purposes when the facts of ownership and control of the corporation approximate those presented by the Southern Pacific Case. The Court of Appeals disagreed. It held that under our decisions, when a corporation carries on business activity the fact that the owner retains direction of its affairs down to the minutest detail, provides all of its assets and takes all of its profits can make no difference taxwise. The court concluded that 'Even though Southern P. Co. v. Lowe (US) supra, set up a different test, we regard it as pro tanto no longer controlling.'

"The result reached by the Court of Appeals is clearly required by our later decisions. Our reluctance to erase Southern Pacific from the books has been due not to any belief that it lays down a correct rule for tax purposes generally, but to the fact that it concerns 'very peculiar facts' which make it clearly distinguishable from later cases involving the tax status of a subsidiary or other wholly owned corporation. For that reason, we have, instead, held that it lays down no rule for tax purposes. Burnet v. Commonwealth Improv. Co. supra, (287 US at p 419, 77 L ed 402, 53 S Ct 198); Moline Properties v. Commissioner, supra (319 US at p 439, 87 L ed 1502, 63 S Ct 1132). That the concept of identity of the corporation with its owner set out in the Southern Pacific Case is

incompatible with later decisions of this Court may be demonstrated by a consideration of the facts enumerated and relied upon by the Tax Court, which based such reliance on the emphasis placed upon similar facts in the Southern Pacific Case. These facts relate to the ownership, control, and right to income reserved by the parent.

"So far as control is concerned, we can see no difference in principle between Airco's control of petitioners and that exercised over Moline Properties, Inc., by its sole stockholder. Undoubtedly the great majority of corporations owned by sole stockholders are 'dummies' in the sense that their policies and day-to-day activities are determined not as decisions of the corporation but by their owners acting individually. We can see no significance, therefore, in findings of fact such as, 'The Airco Board held regular meetings and exercised complete control over Airco and each of the petitioners,' and 'The chairman, vice chairman, and president of Airco were in charge of the administration and management of the activities of each petitioner and carried out the policies and directives with respect to each petitioner as promulgated by the Airco board.' We reversed the Board of Tax Appeals in Moline Properties in the face of its finding that 'Full beneficial ownership was in Thompson [the sole stockholder], who continued to manage and regard the property as his own individually.'

"Some stress was placed by the Tax Court, and by petitioners in argument here, upon the form of ownership of assets adopted by Airco and its subsidiaries. Petitioners' capital stock was, as has been stated, nominal in amount. Assets of considerable value, to which title was held by the subsidiaries, were balanced by accounts payable to Airco on the books of each. The Tax Court thought it material that 'All assets held by each petitioner were furnished to it by Airco, which paid for them with its own cash or stock. Airco supplied all the working capital of each petitioner.'"

* * * * * * *

"Nor do the contracts between Airco and petitioners by which the latter agreed to pay all profits above a nominal return to the former, on that account, become 'agency' contracts within the meaning of our decisions. The Tax Court felt that the fact that Airco was entitled to the profits by contract shows that the income 'belonged to Airco' and should not, for that reason, be taxed to petitioners. Our decisions requiring that income be taxed to those who earn it, despite anticipatory agreements designed to prevent vesting of the income in the earners, foreclose this result. Lucas v. Earl, 281 US 111, 74 L ed 731, 50 S Ct 241 (1930); Helvering v. Clifford, 309 US 331, 84 L ed 788, 60 S Ct 554 (1940); United States v. Joliet & C. R. Co. 315 US 44, 86 L ed 658, 62 S Ct 442 (1942); Commissioner v. Sunnen, 333 US 591, 92 L ed 898, 68 S Ct 715 (1948). Of course one of the duties of a collection agent is to transmit the money he receives to his principal

according to their agreement. But the fact that petitioners were required by contract to turn over the money received by them to Airco, after deducting expenses and nominal profits, is no sure indication that they were mere collection agents. Such an agreement is entirely consistent with the corporation-sole stockholder relationship whether or not any agency exists, and with other relationships as well."

Attention is called to the fact that the subsidiary corporations were not the agents of the parent corporation. It is true it was argued that the subsidiary corporations were agents of the parent corporation, but this was not true as a matter of fact or of law. Each subsidiary was engaged in business in its own name and did not attempt to function in the name of the parent corporation. In fact the Air Reduction Corporation deliberately took action to prevent each of the subsidiaries from acting in the capacity of agent for it. This was done for the specific purpose of preventing suits from being brought against the Air Reduction Corporation in each of the 48 States of the Union. The claim of so-called agency was based apparently upon the theory that the parent corporation controlled the subsidiaries, but this of course did not technically result in the subsidiaries having the status of agents. All corporations are controlled by their stockholders.

The holding of the Supreme Court in this case does not appear to have any bearing on whether a nonexempt cooperative association is entitled to exclude amounts which it is obligated to refund to its patrons on a patronage basis.

In the case at bar, it was admitted that each of the subsidiary corporations had profits, and profits of course are the same as income. The contracts which the subsidiaries had entered into to pay the amount of their profits to the parent corporation, less an amount equal to 6 percent on their stock, was simply a way of disposing of the profits. Indeed, if there had been no contract at all, the parent corporation would obviously have been entitled to the profits on their distribution. In the case of any corporation it is the stockholders who are entitled to receive the profits on their distribution. That is why stockholders become stockholders. The contracts with the parent corporation simply provided a specific way for the distribution of the profits. As pointed out earlier, the subsidiary corporations did not buy of nor sell to the parent corporation. All the profits made by each of the subsidiary corporations arose on account of business transactions entered into by the subsidiaries in their own names with third persons.

In the case of a cooperative association which is under a mandatory obligation at the time it engages in business transactions with its patrons to make refunds to them, this obligation enters into and is an integral part of each business transaction. On account of this fact, the amount of the patronage refunds are not income or profits of the cooperative association any more than the discounts which are commonly allowed by business concerns may be considered as a part of the income or profits of the business concern making them.

In other words, in the case of a cooperative association which is under a mandatory obligation to account to its patrons at the time it engages in business transactions with them, the patronage refunds are just as excludable as the original cost of the goods in the case of a purchasing association are deductible.

The object of the mandatory obligation entered into by the cooperative association to pay patronage refunds is not to return profits or income, but to keep the money in question from having the status of profits or income. In such a case the financial aspects of the original business transactions entered into by the cooperative association are not closed until the association has made patronage refunds to its patrons in accordance with its mandatory obligation to do so.

LANDLORD BUYING TENANT'S SHARE - INCOME TAXES

The following is an unpublished ruling of the Bureau of Internal Revenue:

"TREASURY DEPARTMENT
WASHINGTON 25

Office of
Commissioner of Internal Revenue
- - - - - - - -

Address reply to
Commissioner of Internal Revenue
And Refer to
IT: P:ER-4

(Name of Cooperative is
omitted on purpose)

Gentlemen:

"The records of the Bureau of Internal Revenue show you have heretofore qualified for exemption from Federal income tax under the provisions of section 101(12) of the Internal Revenue Code and/or corresponding provisions of prior revenue acts as a farmers', fruitgrowers', or like association, organized and operated on a cooperative basis within the meaning of that section of the law.

"Pursuant to an examination of the annual information return, Form 990, filed by certain exempt organizations in accordance with the requirements of section 54(f) of the Internal Revenue Code, as added by section 117 of the Revenue Act of 1943, investigations have been made to determine whether such organizations are operating within the requirements of the law under which they are held to be exempt.

"During the course of these investigations it has been found that a number of cooperative organizations, which otherwise appear to

meet the requirements for exemption, are not maintaining proper permanent records which clearly show the value of products marketed or otherwise handled for member producers and the value of products marketed or otherwise handled for nonmember producers, and from which the proportionate shares of patronage dividends due to member and nonmember producers can be determined. This situtation is particularly prevalent in those cooperative associations which include among their membership, individual landowners who operate their farms under an arrangement with a tenant or tenants or a crop-sharing basis, and who, as part of the arrangement market the entire crop through the cooperative association in their own names as members. As a result, it appears that the statutory requirement that the proceeds of the sale of products, less necessary operating expenses be returned to producers on the basis of the quantity or value of products furnished by them, is being violated. There is also the possibility, where this condition exists, that the cooperative associations involved may be marketing the products of nonmembers in an amount the value of which exceeds the value of products marketed for members, which of course, would also be in violation of the requirements of the law. In this connection, attention is directed to the case of Farmers Cooperative Creamery V. Commissioner, 21 B.T.A. 265, in which the Board of Tax Appeals, now The Tax Court of the United States, in defining a producer states:

> "'We believe that the farm owner who operates his farm by tenants on a crop-sharing basis is entitled to be called a producer. He risks his capital, furnishes seed and takes his chances on profits in much the same manner as he would were he to hire the work done for wages. The fact that he receives a crop share of produce including dairy products, is persuasive that he is actually engaged in farming and is a producer of farm products.'

"In view of the foregoing the Bureau has taken the position, generally, that a member of a cooperative association who operates his farm on a crop-sharing basis, is a producer with respect to that portion of the crop which he receives as his share, and the sharecropper or tenant is a producer with respect to that portion of the crop which he receives as his share. Consequently, it follows that the value of products marketed or otherwise handled for members who operate their farms on a crop-share basis must be segregated on the permanent records of the association, from products marketed or otherwise handled for sharecroppers or tenants who are patrons but not members of the cooperative association, in order that the Bureau may properly determine, at any time, whether a cooperative association is operated in a manner which qualifies under the provisions of section 101(12) of the Internal Revenue Code, and that there has been no violation of any one or more of the requirements thereunder.

"Your status as previously determined by the Bureau will not be disturbed at this time. However, you will be required to reestablish your exempt status after the close of the calendar year 1948 (or the fiscal year ending in 1949, in the event you operate on a fiscal year basis). You should after the close of such calendar or fiscal year execute and return the enclosed exemption affidavit, Form 1028, together with a complete and detailed financial statement showing your receipts, expenditures, assets and liabilities for that year. The financial statements should clearly show: (1) the value of products marketed, or otherwise handled for members, and (2) the value of products marketed or otherwise handled for nonmembers. Under (2) you should include the value of products marketed or otherwise handled through members, pursuant to either an oral or written crop-share agreement. <u>In the event any of your patrons operate their farms on a crop-share basis, you must furnish an affidavit, properly sworn to by one of your principal officers stating such fact and also stating whether or not:</u>

"1. The value of products marketed or otherwise handled for the sharecropper has been included in the amount shown on your financial statement as business done with nonmembers.

"2. All patrons, including the sharecroppers, or tenants have been paid or credited with their aliquot share in the distribution of patronage dividends.

"In reestablishing your status for Federal income tax purposes after Dec. 31, 1948, the information furnished should be marked for the attention of IT:P:ER-4.

"The collector of internal revenue for your district is being advised of this action.

Signed: E. I. McLarney, Deputy Commissioner"

(Underscoring added.)

The foregoing ruling is applicable to instances in which a landlord who is a member of a cooperative association buys from his nonmember tenant or sharecropper the share of the crop to which the tenant or sharecropper is entitled and then delivers all the crop to his cooperative association. The ruling would also include other instances in which a landlord markets in his own name the tenant's or sharecropper's share of the crop. It is assumed that the landlord would deliver the product in his own name and would receive the patronage refunds which might be made on account of such commodities.

The Bureau has previously held that where members of a cooperative are engaged in making purchases of agricultural commodities from others, which commodities are then delivered to the cooperative association of which the buyers are members, this may operate to cost the cooperative association

its exemption. (See Summary No. 35, p. 11.) Apparently the Bureau of Internal Revenue is applying the same principle in instances in which a landlord markets in his own name through his cooperative the share of the crop to which his tenant or sharecropper is entitled. It is proceeding upon the theory that cooperative associations may market only the products that are produced by and received from their members or "other producers." Of course, under the statutory provisions providing for exemption, a cooperative association should not market commodities received from dealers or other nonproducers.

The ruling under discussion is applicable only to instances in which tenants or sharecroppers are entitled to a portion of the crop. This would at least ordinarily mean that the landlord was not the producer with respect to the share of the crop to which the tenant or sharecropper is entitled. If, under the legal relationship between the landlord and the person referred to as "tenant" or "sharecropper," the landlord is the producer and owner of all the agricultural commodities produced, then the landlord could not purchase any share of them. This situation would apparently result if the "tenant" or "sharecropper" had the status of an employee instead of that of a producer or owner of a share of a crop.

Under the foregoing ruling the burden is apparently placed upon the management of a cooperative association to determine if any of its members are engaged in marketing in their own names agricultural commodities with respect to which their tenants or sharecroppers were the owners or producers.

Attention is called to the fact that the foregoing ruling proceeds on the theory that agricultural commodities marketed by a landlord who is a member of a cooperative, and obtained by him from his tenant or sharecropper, have the status of nonmember business in determining if the association is doing more business for nonmembers than it is for members.

EXEMPTION LOST - NO RECORDS

The following is an unpublished ruling of the Bureau of Internal Revenue:

"TREASURY DEPARTMENT
WASHINGTON 25

"Office of
COMMISSIONER OF INTERNAL REVENUE FEB. 18, 1949

"Address Reply To
Commissioner of Internal Revenue
and Refer to
IT:P:ER
JJW

Name of Cooperative Omitted
on Purpose

Gentlemen:

"Reference is made to your letter of July 19, 1948, and a conference in this office accorded your auditor, Mr. ____________, relative to having Bureau ruling of January 22, 1946, in which a Bureau ruling dated October 1, 1935, holding that you are entitled to exemption for Federal income tax purposes, is modified to require you to file income tax returns for 1939 and subsequent years, reversed. The action taken by Bureau ruling of January 22, 1946, resulted from your failure to furnish complete evidence requested by this office for use in determining your status for income tax purposes under the provisions of section 101(12) of the Internal Revenue Code.

"In the file of your case is correspondence received from you in which you admit that you had never required your patrons for whom you marketed livestock to meet your requirements for membership; that during the year 1944 you marketed livestock having a value of $2,931,973.34 for patrons who had not met membership requirements; and that in some years records were not kept of the amount of business transacted with members and nonmember patrons, respectively. Furthermore, in your letter of July 19, 1948, you state that you have engaged in marketing livestock for patrons which was not produced by them, which is an activity outside the purposes of an exempt farmers' cooperative association.

"A review of the entire file of your case clearly shows that you have not been operated in such a manner as to meet the requirements of an exempt corporation as contemplated by section 101(12) of the Internal Revenue Code. Accordingly, the Bureau ruling of January 22, 1946, is affirmed, and you are required to file income tax returns on Form 1120, for 1939 and subsequent years.

"This ruling is made without prejudice to any claim which you may file for 1948 or subsequent years.

"A copy of this letter is being transmitted to the collector of internal revenue for your district.

"By direction of the Commissioner.

Very truly yours,

/s/ C. W. Stowe
Acting Deputy Commissioner"

In order for a cooperative association to be exempt from the payment of Federal income taxes under paragraph 12 of section 101 of the Internal Revenue Code, it must maintain permanent records. This is necessary in order that the Bureau of Internal Revenue may be able to ascertain at

any time if the association qualified for exemption in a particular year. It is assumed that permission could be obtained from the Bureau of Internal Revenue to destroy records, but in the absence of such permission, they should not be destroyed.

In the foregoing ruling, attention was called to the fact that the association in question in some years had not maintained records showing the amount of business transacted with members and with nonmembers. Inasmuch as one of the conditions for exemption is that an association may not do more business for nonmembers than it does for members, a failure to have records covering the matter would cost the cooperative its exemption.

Particular attention is called to the statement appearing in the foregoing ruling reading: "Furthermore, in your letter of July 19, 1948, you state that you have engaged in marketing livestock for patrons which was not produced by them, which is an activity outside the purposes of an exempt farmers' cooperative association." (Underscoring added.) This statement is of course consistent with the other unpublished ruling of the Bureau of Internal Revenue which appears in this Summary.

NEW DIRECTORSHIPS NOT VACANCIES

The case of Automatic Steel Products, Inc., et al. v. Johnston, et al., 64 A 2d 416, decided by the Supreme Court of Delaware, involved the question of whether under the General Corporation Law of Delaware a board of directors is empowered to fill newly created directorships.

Article 2 of the bylaws of Automatic Steel Products, Inc., provided that:

> "'Any vacancy in the Board of Directors caused by * * * an increase in the Board of Directors * * * may be filled by the majority vote of the remaining Directors, even though less than a quorum, at any meeting, or by the Stockholders of the corporation at the next annual meeting or any special meeting * * *.'" (Underscoring added.)

The General Corporation Act of Delaware authorized the filling of vacancies on a board of directors by a majority of the remaining directors. The board of directors of Automatic Steel Products, Inc., acting in pursuance of an appropriate bylaw increased the number of directorships of that corporation, and then the board of directors proceeded to fill the new directorships which had been created. Suit was then instituted to have the election of the new directors held invalid.

The court below held that the board of directors did not have the authority, under the law of Delaware, to elect directors to fill newly created directorships. In other words, the court held that a newly

created directorship did not represent a vacancy within the meaning of the statute. In affirming the judgment of the court below, the Supreme Court of Delaware said in part:

"In the Moon Motor Car Company case, 151 A. at page 302, Chancellor Wolcott took occasion to say: 'It is conceded that newly created offices of directors present no question of "vacancies" and hence are not to be filled under the vacancy provisions of the section. The places are therefore to be filled by election by the stockholders.'

"Elsewhere on the same page, Chancellor Wolcott said: 'With respect to such places power to fill them resides inherently in the stockholders and it may be exercised forthwith.'

"The McWhirter and Gow decisions are to the same effect.

"This conclusion is in accord with the general law, Gold Bluff Mining and Lumber Corporation v. Whittlock, 75 Conn. 669, 55 A. 175; In re A. A. Griffing Iron Co., 63 N.J.L. 168, 41 A. 931; and the text authorities support this view, 19 Corpus Juris Secundum Corporations, § 716, page 33; 2 Fletcher Cyclopedia of Corporations, Section 286, pages 42 and 43.

"The cases cited by counsel for Automatic are generally distinguishable, involving as they do, elections to public offices and the interpretation of constitutional and statutory provisions regulating public elections. Automatic's counsel argues that the provisions of certain sections of our General Corporation Law are sufficiently comprehensive to warrant contrary conclusions to those arrived at by Chancellor Wolcott and Vice Chancellor Seitz. He points to Sections 5(8), 9, 13, and 59 of the Corporation Law, Rev. Code 1935, §§ 2037, subd. 8, 2041, 2045, 2091, as being of such broad implication as to justify the inference that Stockholders have the inherent power to delegate to Directors the authority to fill vacancies caused by an increase in the number of the Board. Concededly, Section 5, Paragraph 8, and Section 9 of the General Corporation Law, among others, purport to confer very wide powers upon the Directors in and about the conduct of intra-corporate matters. For example, Section 5, Paragraph 8, provides: 'The Certificate of Incorporation may also contain any provision which the incorporators may choose to insert for the management of the business and for the conduct of the affairs of the corporation, and any provisions creating, defining, limiting, and regulating the powers of the corporation, the directors and the stockholders, or any class of the stockholders, or, in the case of a corporation which is to have no capital stock, of the members of such corporation; provided, such provisions are not contrary to the laws of this State.'

"Section 9 reads as follows: 'The number of directors which shall constitute the whole board shall be such as from time to time shall be fixed by, or in the manner provided in, the by-laws, but in no case shall the number be less than three.'

> "Conceding, arguendo, that the language of the above sections, taken alone, is of such broad import as to justify the inference that corporate Directors may fill vacancies caused by the creation of additional Directorships, nevertheless, the wording of these sections must be construed in the light of the limitations imposed by other pertinent sections of the Corporation Law and, particularly, of Section 30, which deals specifically with vacancies. This section has been construed by an unbroken line of decisions of the Court of Chancery limiting the power of Directors to the filling of only those vacancies where there was a previous incumbency. Moreover, the words '<u>remaining Directors</u>' as used in the second paragraph of Section 30, 'Vacancies shall be filled by a majority of the remaining directors * * *', lend substantial support to the conclusion that the word 'vacancies' implies a previous incumbency. Nor can we ignore the fact that since the most recent of Chancellor Wolcott's opinions on this subject, the Legislature of this State has met on seven occasions without amending Section 30 to obtain the result contended for by defendant. This is not to say that defendant's argument is without merit, but the long settled decisions of this State to the contrary, supported as they are by sound reasoning, persuade the conclusion that the existing law should remain undisturbed. It follows that the By-law under consideration must be held to be invalid." (Underscoring added.)

Automatic Steel Products, Inc., was the result of a merger, and the bylaw providing for the filling of newly created directorships by the board of directors was in the bylaws of that corporation at the time of the merger. It was contended that the plaintiffs were estopped to raise a question regarding the right of the board of directors to fill newly created directorships because they had in effect voted for the bylaw under which this was done. The court, however, held that the doctrine of estoppel was not applicable. In general, if a member votes in favor of a bylaw, he would be estopped to challenge its validity. (See in this connection <u>Farrier</u> v. <u>Ritzville Warehouse Co.</u>, 116 Wash. 522, 199 P. 984; <u>Kent</u> v. <u>Quicksilver Mining Co.</u>, 78 N.Y. 159, 12 Hun. 53.)

NONPROFIT COOPERATIVE NOT AN EMPLOYER UNDER WORKMEN'S COMPENSATION LAW

In the case of <u>Flint Electric Membership Corporation</u> v. <u>Posey</u>, 51 S.E. 2d 869, decided by the Court of Appeals of Georgia, it appeared that Mrs. Thelma McCrary Posey brought an action against the corporation for damages for the death of her minor son. The corporation demurred to the complaint and asked that the action be dismissed on the ground that any proceeding for the recovery of compensation should have been brought under the Workmen's Compensation Law. This squarely presented the question of whether the electric corporation was an employer within the meaning of that law. If the term "employer" was so defined in that law as not to embrace a nonprofit corporation, and if the electric corporation was such a corporation, then the action for damages could be maintained entirely independent of the Workmen's Compensation Law.

The Court specifically held that the language "and any individual, firm, association or corporation engaged in any business operated for gain or profit" did not include an electric cooperative corporation organized under the statutory provisions of Georgia for the formation of such corporations. Hence, it was held that the suit for damages could be maintained. The following quotation from the opinion discloses the basis thereof:

"By the provisions of the Workmen's Compensation Law, Code Ann. Supp. § 114-101, an employer is defined as follows: '"Employer" shall include the State of Georgia and all departments thereof, any municipal corporation within the State, and any political division thereof, and any individual, firm, association or corporation engaged in any business operated for gain or profit [italics ours], except as hereinafter provided, and the receiver or trustee of the same, and the legal representative of a deceased employer, using the service of another for pay. If the employer is insured this term shall include his insurer as far as applicable.' Code Ann. Supp. § 114-107 provides, in part, that 'This Title shall not apply to * * *; nor to any persons, firm, or private corporation, including any public service corporation, that has regularly in service less than 10 employees in the same business within this State, unless such employees and their employers voluntarily elect to be bound.' The defendant in the petition in this case is named as the Flint Electric Membership Corporation, and it is alleged that the defendant is a Georgia corporation, with its principal office and place of business in Reynolds, Taylor County, Georgia. Title 34A of the Code Ann. Supp., Ga. L. 1937, p. 644, and amendments thereto, provided for the organization and operation of cooperative and nonprofit electric membership corporations. Certain sections of this law are as follows: Code Ann. Supp. § 34A-103: 'Cooperative, nonprofit, membership corporations may be organized under this Chapter for the purpose of engaging in rural electrification by any one or more of the following methods: (1) The furnishing of electric energy to persons in rural areas who are not receiving electric service from any corporation subject to the jurisdiction of the Georgia Public Service Commission, or from any municipal corporation. (2) Assisting in wiring of the premises of its members or the acquisition, supply, or installation of electrical or plumbing equipment therein. (3) The furnishing of electric energy, wiring facilities, electrical or plumbing equipment or services to any member corporation organized under this Chapter.' Code Ann. Supp. § 34A-108: 'The words "electric membership corporation" shall not be used in the corporate name of corporations hereafter organized under the laws of this State, or authorized to do business herein, other than those organized pursuant to the provisions of this Chapter.' Code Ann. Supp. § 34A-115: 'Each corporation shall be operated without profit to its members, but the rates, fees, rents or other charges for electric energy and any other facilities, supplies, equipment, or services furnished by the corporation shall be sufficient at all times: (1) To pay all operating and maintenance expenses necessary or desirable for the prudent conduct of its business

and the principal of and interest on the obligations issued or assumed by the corporation in the performance of the purpose for which it was organized, and (2) For the creation of reserves.' Nonprofit organizations do not come under the definition of employer as defined in the Workmen's Compensation Law. Code Ann. Supp. § 114-101, supra. In Hall v. Georgia Milk Producers Confederation, 61 Ga. App. 676, 7 S.E. 2d 330, it was held that the Georgia Milk Producers Confederation, organized and existing under the provisions of the Cooperative Marketing Act, Code § 65-201 et seq., as a nonprofit organization, was not subject to the provisions of the Workmen's Compensation Law. Under the circumstances shown in the present case, the name of the defendant would carry with it a presumption that the defendant is lawfully organized and operating as an electric membership corporation, unless and until the contrary may be shown, and as such, is not an employer within the definition of the term as used in the Workmen's Compensation Law." (Underscoring added.)

Apparently the court proceeded on the theory that inasmuch as the statute under which the electric cooperative was incorporated contemplated that such organizations would be nonprofit in character it followed as a matter of fact that any cooperative organized thereunder was a nonprofit corporation. In other words, from the standpoint of the law of Georgia at least, that State had declared that any association organized under the statute in question would be a nonprofit corporation.